Nos. 12,471-12,476

In the United States Court of Appeals for the Ninth Circuit

SAM SCHNITZER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ESTATE OF HARRY J. WOLF, DECEASED, BY MONTE L. WOLF, ADMINISTRATOR, DE BONIS NON WITH THE WILL ANNEXED OF SAID ESTATE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

MONTE L. WOLF, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

BLOSSOM M. GOLDSTEIN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

CHARLOTTE C. COHON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ESTATE OF JENNIE WOLF, DECEASED, BY MONTE L. WOLF, ADMINISTRATOR DE BONIS NON WITH THE WILL ANNEXED OF SAID ESTATE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

OPINION BELOW

The only previous opinion (R. 28-70)[1] is the opinion of the Tax Court, *en banc,* which is reported in 13 T. C. 43.

[1] Record references are to the record in No. 12,471, *Sam Schnitzer, v. Commissioner,* unless otherwise noted.

JURISDICTION

The above entitled six cases, consolidated for trial in the Tax Court (R. 548), were by order of this Court consolidated for the purposes of printing the record on appeal, briefing, hearing, argument, and decision (R. 547-549). The petitions for review in each case involve federal income and victory taxes for the year 1943.[2]

The Commissioner of Internal Revenue mailed to each of the taxpayers a notice of deficiency in income and victory tax in the respective amounts below stated for the calendar year ending December 31, 1943, on the dates below stated, as follows:

Docket No.	Taxpayer	Date	Amount of Deficiency	Record References
12,471	Sam Schnitzer............	3/3/47	$151,044.45	R. 2–3, 16–20
12,472	Estate of Harry J. Wolf...	3/3/47	151,049.05	R. 2–3, 17–21
12,473	Monte L. Wolf...........	3/4/47	42,273.99	R. 3, 16–19
12,474	Blossom M. Goldstein.....	3/4/47	42,273.99	R. 3, 16–19
12,475	Charlotte C. Cohon.......	3/4/47	42,273.99	R. 2–3, 16–19
12,476	Estate of Jennie Wolf.....	3/3/47	42,273.99	R. 3, 17–20

As appears from these notices of deficiencies, the deficiencies determined against taxpayers Monte L. Wolf, Goldstein and Cohen, respectively, were based upon their liability as transferees of the Estate of Jennie Wolf, Deceased.

Within ninety days thereafter and on the date below stated, each of the above entitled taxpayers filed a petition with the Tax Court for redetermination of the

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[2] No. 12,471, *Schnitzer* v. *Commissioner*, R. 72-76; No. 12,472, *Estate of Harry J. Wolf, Deceased* v. *Commissioner*, R. 31-36; No. 12,473, *Monte L. Wolf* v. *Commissioner*, R. 36-40; No. 12,474, *Goldstein* v. *Commissioner*, R. 37-42; No. 12,475, *Cohon* v. *Commissioner*, R. 37-41; No. 12,476, *Estate of Jennie Wolf, Deceased* v. *Commissioner*, R. 31-36.

deficiency under the provisions of Section 272 of the Internal Revenue Code:

Docket No.	Taxpayer	Date	Record references
12,471	Sam Schnitzer......................	5/26/47	R. 2–15, 20
12,472	Estate of Harry J. Wolf.............	5/26/47	R. 2–17, 21
12,473	Monte L. Wolf......................	5/29/47	R. 2–15, 19
12,474	Blossom M. Goldstein...............	5/29/47	R. 2–15, 19
12,475	Charlotte C. Cohon.................	5/29/47	R. 2–15, 19
12,476	Estate of Jennie Wolf..............	6/ 2/47	R. 2–16, 20

The final order and decision of the Tax Court was entered in each case on November 9, 1949, determining that there is a deficiency on the part of each of the taxpayers below listed in income and victory tax for the calendar year 1943 in the amounts respectively below stated:

Docket No.	Taxpayer	Amount of deficiency determination	Record references
12,471	Sam Schnitzer......................	$43,287.42	R. 71
12,472	Estate of Harry J. Wolf.............	43,282.00	R. 30
12,473	Monte L. Wolf......................	42,273.99	R. 35
12,474	Blossom M. Goldstein...............	42,273.99	R. 36
12,475	Charlotte C. Cohon.................	42,273.99	R. 36
12,476	Estate of Jennie Wolf..............	42,273.99	R. 30

The tax liability here involved in the aggregate for all six cases is $128,843.41, since the maximum total tax liability in the last four cases together is limited to $42,273.99, taxpayers Monte L. Wolf, Goldstein and Cohon, as set forth *infra,* being liable only as transferees of the Estate of Jennie Wolf.

The case is brought to this Court by petitions for review filed by each taxpayer, respectively, on January 4, 1950:

Docket No.	Taxpayer	Record references
12,471	Sam Schnitzer............................	R. 72–77
12,472	Estate of Harry J. Wolf..................	R. 31–36
12,473	Monte L. Wolf............................	R. 36–41
12,474	Blossom M. Goldstein.....................	R. 37–42
12,475	Charlotte C. Cohon.......................	R. 37–42
12,476	Estate of Jennie Wolf....................	R. 31–37

within three months after the Tax Court's decision was rendered, pursuant to the provisions of Section 1141(a)

of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948, and Section 1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

1. Whether or not the Tax Court was clearly erroneous in concluding that advances in the amount of $202,350 which taxpayers (or their transferor) made to a corporation, of which they were stockholders, constituted capital contributions and not loans and, hence, not deductible, as bad debts within the meaning of Section 23(k)(1) of the Internal Revenue Code.

2. In any event, whether or not the loss was incurred in taxpayers' trade or business within the meaning of Section 23(k)(4) of the Internal Revenue Code, and, hence, deductible only at the limited capital loss rates.

STATUTE AND REGULATIONS INVOLVED

The statute and Regulations involved will be found in the Appendix, *infra*.

STATEMENT

The decision below was reviewed by the entire Tax Court. (R. 70.) Based on the testimony of eleven witnesses, taken before Judge Luther A. Johnson (R. 78-524) in three days of hearing and on documentary evidence, the Tax Court made the following fact findings:

Taxpayer, Sam Schnitzer, and Harry J. Wolf, deceased, residents of Portland, Oregon, in 1942 and 1943 prepared their income tax returns for those years on the cash basis and filed them with the Collector of Internal Revenue for the District of Oregon. Harry J. Wolf died on February 6, 1948, and his son, Monte L. Wolf, is the personal representative of the Estate of Harry J. Wolf, taxpayer in Docket No. 12,472. Monte

L. Wolf is also administrator *de bonis non* with the will annexed of the Estate of Jennie Wolf, deceased, taxpayer in Docket No. 12,476. Jennie Wolf, wife of Harry J. Wolf, died on April 8, 1945, a resident of Portland, and the owner of property in excess of the deficiencies in tax asserted against her. She filed her income tax returns, prepared on the cash basis, for 1942 and 1943 with the Collector of Internal Revenue for the District of Oregon. Monte L. Wolf, Blossom M. Goldstein, and Charlotte C. Cohon, taxpayers in Docket Nos. 12,473, 12,474, and 12,475, also residents of Portland, are children of Harry J. and Jennie Wolf, and received, as distributees of the residue of Jennie Wolf's estate, assets of a fair market value of $22,923.09, $23,855.57, and $24,112.08, respectively. The distribution of these assets left the estate without means to pay taxes, and, as they stipulated (R. 528-529), these taxpayers became thereby liable as transferees for any deficiency in tax of the transferor estate to the extent of the value of property received by each. (R. 32-33.)

During the years 1942 and 1943 Sam Schnitzer and Harry J. Wolf were active in the operation of the Alaska Junk Company (hereinafter called Alaska Junk), a partnership engaged in the business of buying, selling, and generally dealing in junk, pipe, tools, machinery, hardware, scrap, and other metal products at Portland. The books of Alaska Junk were kept on an accrual basis, and partnership returns, prepared on that basis, were filed for that firm in 1942 and 1943 with the Collector of Internal Revenue for the District of Oregon. On these returns Sam Schnitzer and his wife, Rose Schnitzer, and Harry J. Wolf, and his wife, Jennie Wolf, were listed as partners, and a share of profits was reported as distributable to each. (R. 33-34.)

As Alaska Junk expanded its activities and grew in financial strength, it occasionally made loans or

advances to customers in the expectation of maintaining or increasing its trade. These advances were made sometimes when the customer was indebted to it for goods and were charged to his open account. The books indicate such advances aggregating $1,600 to M. Turn; $4,479.63 to Munce & Pedrante; $1,510 to R. Pedrante; $2,750 to Emil Nyberg; $4,500 to the Marshfield Bargain House; $8,000 to the Medford Bargain House, and $1,971.08 to various others. All of these customers bought scrap and sold it to Alaska Junk or hauled scrap for Alaska Junk, and most of the advances were repaid by cash or by credit for scrap supplied. Some were not repaid. (R. 38-39.)

Alaska Junk also made very large advances to enterprises in which members of the Wolf and Schnitzer families were interested. Schnitzer's son, Morris, individually operated a scrap business under the assumed name of Schnitzer Steel Products Company. Between July 1936 and March 1948 Alaska Junk made to him cash advances aggregating $119,020.99, of which $17,517.37 was repaid in cash and the rest in scrap. In 1939 Wolf, Schnitzer, and their wives organized the Central Supply Company as a wholesale dealer in plumbing and electric goods. The organizers, in payment for its capital stock, placed $50,000 to its credit in an account with Alaska Junk, and Alaska Junk thereafter made to it aggregate cash advances of $15,500, and also sold it goods. Charges to the account have been paid. In 1939 Wolf, Schnitzer, and their wives and Morris Schnitzer incorporated Industrial Air Products Company for the manufacture of oxygen and acetylene. Alaska Junk was charged with the amount of the stock subscription. Thereafter it made cash advances aggregating $94,427.03, and it sold merchandise to the company. Repayment was made. In 1940 Wolf, Schnitzer, and their wives and one Shea organized the Plumbing & Heating Sales Company. Alaska Junk

advanced the money for its capital and made sales to it and purchases from it. In 1941 Alaska Junk and Dulien Steel Products Company formed the Carlton Coast Railroad Liquidators as a joint venture to acquire and dismantle a logging camp and railroad and to sell the salvaged materials. Alaska Junk advanced $27,525 for the venture and acquired a 50% participation, and it has received $134,649.94 from it. The partnership kept open accounts with all the persons and firms to whom the above mentioned advances were made, charging to such accounts all cash advanced and merchandise furnished, and crediting them with payments in cash or in goods bought by it. (R. 39-40.)

On June 4, 1941, Morris Schnitzer, son of Sam Schnitzer, organized the Oregon Electric Steel Rolling Mills (hereinafter usually called Oregon Steel) as an Oregon corporation with an authorized capital of $250,000, represented by 2,500 shares of stock of a par value of $100 each. Of the authorized shares, subscription was made for 1,878 shares as follows (R. 40):

	Shares	Par value
Morris Schnitzer	1,250	$125,100
Sam Schnitzer	312½	31,250
Harry J. Wolf	312½	31,250
Bernard Levin	1	100
Louis Schnitzer	1	100

On June 12, 1941, 1 share was issued to each of the 5 subscribers; on August 4, 1 share was issued to L. N. Rosenbaum; and on February 10, 1942, 1,251 shares were issued to Morris Schnitzer, 312½ to Sam Schnitzer, and 312½ to Harry J. Wolf. On February 10, 1942, Sam Schnitzer and Wolf surrendered their 312½ share certificates and 4 new certificates for 156¼ shares each were issued to each of them and their wives. There were also changes in the holders of one share. (R. 41.)

Oregon Steel was organized to erect and operate a rolling mill for the manufacture of steel products. Its stockholders planned to melt down and use scrap metal,

which in 1941 was being sold in Portland at $1.50 to $2 a ton less than in Seattle, and on the basis of engineers' production estimates they expected the earnings eventually to reach $50,000 or more a month. Morris Schnitzer, with whom the idea originated, was made president and general manager. He had been engaged for some years in the purchase and sale of new and used iron, steel, tools, and machinery in Portland under the trade name of Schnitzer Steel Products Company, had had considerable experience in salvage enterprises in various parts of the country, and had studied engineering and business administration at the University of Washington. He was active in seeking capital for Oregon Steel, in getting engineering advice and trade information, and in procuring materials and the necessary priorities. He consulted various steel men and jobbers, arranging outlets for prospective products, and made numerous business trips to New York and Washington. He experienced great difficulties in getting the enterprise started, and actual construction of the mill did not begin until November 1942. Sam Schnitzer, the vice president, and Harry J. Wolf, the secretary, also rendered services. The corporation's board of directors was composed of Morris, Sam and Rose Schnitzer, and Harry J. and Jennie Wolf. None of them had had any experience in steel production. (R. 41-42.)

From October 1941 Alaska Junk made numerous advances of cash to Oregon Steel, supplied it with goods of various kinds at cost, and paid bills for it. The amounts of cash advanced, the bills paid, and the value of the goods furnished were charged to its open account with Alaska Junk. As Alaska Junk had less than $10,000 cash normally on hand, it often secured bank loans to provide cash advances. Morris Schnitzer likewise advanced cash, paid bills, and supplied goods, and these amounts, together with the expenses of his business trips, were charged to the corporation's account

with Schnitzer Steel Products Company. Nearly all of the advances were for plant and equipment, but after operations began $9,460 in scrap was furnished by Alaska Junk. All of the foregoing charges were reflected by corresponding credits to the accounts of Alaska Junk and Schnitzer Steel Products Company on the corporation's books. On November 30, 1942, the corporation's account with Alaska Junk showed a debit balance of $299,069.70 and its account with Schnitzer Steel Products Company, a debit balance of $138,984.11. On an office memorandum Sam Schnitzer referred to these advances as "contributed capital." (R. 42-43.)

During 1941 Morris Schnitzer made numerous attempts to procure outside capital. In June he besought New York investment banking houses to make a public offering of Oregon Steel's stock, but they declined on the grounds that no proper engineering reports had been submitted and the organizers lacked adequate experience. The Commercial Credit Corporation refused to make a loan because they deemed the $250,000 authorized capital too small. For the same reasons the Bank of America refused a loan in November 1941. The Bank of Portland refused a loan in April 1942, despite oral assurances by the corporation's officers that $1,000,000 would be invested in the plant and more would be available for working capital. In October 1941 the corporation filed application with the Reconstruction Finance Corporation for a loan of $600,000 and employed the engineering firm of MacDonald Bros., Inc., to make a survey and report on the necessary investment and probable operating costs. On this application Morris Schnitzer, signing as president, stated that the corporation proposed to expend $550,000 of the proceeds on buildings and equipment and $50,000 on raw materials, brick, manganese, scrap, etc. He estimated that the plant would cost $890,000, and stated that capital was then $187,700, but added:

"We expect to increase the capital of this corporation shortly. Additional stock will be taken by S. Schnitzer and J. Wolf to equal that of M. Schnitzer." On the MacDonald report, filed with the RFC on November 10, 1941, cost of the mill and equipment was put at $987,035, exclusive of engineering, legal, traveling, and organization expenses. Organization expenses were given as $65,000. (R. 43-44.)

The RFC was not satisfied with the MacDonald report, and a second was submitted from another engineer, who estimated that the mill would cost $1,050,000. On April 2, 1942, the executive committee of the RFC approved the loan, subject to listed conditions. After several changes had been made in the conditions, Sam Schnitzer and Wolf, as partners of Alaska Junk, wrote RFC on December 1, 1942, that cost of the mill might exceed $1,200,000 and that Alaska Junk would furnish any necessary money in excess thereof to complete the project if RFC would lend an additional $100,000. On December 4, 1942, RFC approved a loan of $700,000, having received assurance that there had been no change in the borrower's financial condition and business prospects. Oregon Steel gave to the Federal Reserve Bank of San Francisco its 4 per cent promissory note for that amount, dated December 15, 1942, payable within 5 years by monthly installments of $6,500 from May 1, 1943, and by an additional annual payment sufficient to make all payments equal to 50 per cent of the corporation's net earnings for the preceding year. The note was secured by a duly recorded mortgage on the corporation's real estate and the plant to be constructed and equipped and on its personal property with the exception of cash, receivables, raw materials, and inventories. Effective supervisory powers were given to RFC to enforce current compliance with the terms. (R. 44-45.)

By separate agreement Morris, Sam and Rose Schnitzer, and Harry J. and Jennie Wolf individually

guaranteed repayment of the note and bound themselves to supply "additional working capital" in amounts deemed satisfactory by RFC as long as any part of the loan should remain unpaid. The corporation bound itself to limit officers' annual salaries for such period to a total of $25,000, and to pay in cash no more than $15,000. In an instrument of December 29, 1941, the corporation, Morris Schnitzer, and Alaska Junk recited that Morris Schnitzer and Alaska Junk had already contributed $138,984.11 and $299,069.70, respectively, in the form of cash or property to the corporation; that (R. 45):

> * * * Such contributions by stockholders have, as stated, been as a capital investment, and in no wise as outstanding accounts payable by Borrower, except to the extent that Borrower's debenture notes may be issued for a part of such contributions or capital investment.

The stockholders further agreed that they would receive in payment of "all such capital investments so made" only the common stock or debenture notes of the corporation and the corporation in turn covenanted to make payments in no other way. The corporation further agreed that, as long as any part of the RFC loan should remain unpaid, it would not issue to stockholders any preferred stock or evidence of indebtedness except debentures on a prescribed form "in return for advances made or to be made by them." The prescribed form forbade payment of principal or interest on the debentures until full repayment of the RFC loan. These conditions were observed, but RFC did allow reimbursement for about $114,519 of subsequent advances for the purchase of mill equipment. (R. 45-46.)

While the final terms of the RFC loan were being arranged, Wolf expressed dissatisfaction because Mor-

ris Schnitzer, holding two-thirds of the corporate stock, had not made a proportionate part of the advances. Costs of the enterprise had already exceeded anticipations, and Morris was financially unable to advance more. The stockholders entered into negotiations among themselves for a more satisfactory distribution of interests. They reached an agreement, and pursuant thereto the corporate directors authorized issuance of debenture bonds for $250,000 on terms contemplated by the understanding with RFC. On January 12, 1943, it issued such bonds in an aggregate of $249,000 to its stockholders in the following amounts (R. 46):

Morris Schnitzer	$75,000
Sam Schnitzer	44,000
Rose Schnitzer	43,000
Harry J. Wolf	44,000
Jennie Wolf	43,000

These bonds bore 8 per cent interest and were payable within 10 years of issue, but no payment of interest or principal could be made while any balance remained due on the corporation's $700,000 note to RFC. (R. 47.)

As part of the settlement agreement Morris Schnitzer on March 11, 1943, surrendered 626 of his 1,251 shares of stock. One share was reissued to Monte L. Wolf and the remainder to Sam Schnitzer and wife and Harry J. Wolf and wife, so that the corporation's 1,878 outstanding shares were thereafter held as follows (R. 47):

	Shares		Shares
Morris Schnitzer	625	Harry J. Wolf	313½
Sam Schnitzer	313½	Jennie Wolf	312½
Rose Schnitzer	312½	Monte Wolf	1

By entries of March 31, 1943, the corporation charged the open account of Schnitzer Steel Products Company (Morris Schnitzer) with $75,000 for "debentures issued" and with $62,500 "to offset bal. of stock subscriptions due against Acc. Pay.," leaving a credit balance of $6,638.23 in the account. By entries of the same

date it charged Alaska Junk's open account with $174,000 "to record debentures issued" and with $124,900 "to offset bal. of stock subscriptions due against Acc. Pay.," leaving a balance of $315,095.41 in that account. By entries of July 14, 1943, Alaska Junk credited the corporation's account by corresponding amounts, specifying that the shares and bonds had been issued to Sam and Rose Schnitzer and to Harry J. and Jennie Wolf in the amounts above set forth. No other shares were ever issued, although in the beginning the organizers expected to issue more to associate promoters. (R. 47-48.)

In connection with the bond issue and stock transfer Morris Schnitzer orally agreed with Sam and Rose Schnitzer and Harry J. and Jennie Wolf that he would bear one-third of any loss that might result from the total amounts advanced and to be advanced by all five to the corporation, over and above the advances credited to stock subscriptions. They in turn agreed to bear two-thirds of any such loss. Morris Schnitzer and Alaska Junk continued thereafter to make advances, as before, and these advances were credited to their open accounts with the corporation in the same way as before and charged to the corporation's open accounts with them. (R. 48.)

In asking for larger releases of the authorized loan, Morris Schnitzer on March 18, 1943, wrote RFC that costs were rising and that the stockholders had "in this job over $700,000 of our own money," but "never originally intended to put in over * * * the $500,000 we were supposed to put in as our share in the capital investment." In a prior letter of December 23, 1942, he had referred to "additional costs for the extensions and additions" to the plant, suggested in the McKee report to increase production capacity, and requested approval of them. (R. 48-49.)

Construction work on the mill began in November 1942, but building materials were hard to obtain; new machinery was scarce; priorities could not be procured for some requirements; and second-hand equipment and materials had to be used in part. Prices steadily increased. The mill was finally completed in June 1943 at a cost of $1,400,000, and the melting of scrap into ingot started soon thereafter. About the same time Morris Schnitzer entered the military service, and his brother, Manuel Schnitzer, who had been employed by the corporation since the preceding January, took charge. Manuel was not familiar with steel manufacture; two engineers, successively engaged as managers, proved unsatisfactory; and competent personnel and operators were difficult to find. Manuel made vigorous efforts, however, and rolling operations were begun late in August. But the machinery did not function properly; production was so far behind schedule that many large orders were canceled by customers, principally the United States Government; creditors pressed for the payment of bills; there was a lack of ready cash; and a serious financial crisis developed. In June 1943 the corporation began to get some relatively small loans from banks, secured by its steel inventory and warehouse receipts for scrap. By November 26 these amounted to $149,499.71. (R. 49.)

The stockholders again tried unsuccessfully to interest outsiders to take a participating interest, and approached the United States Steel Company, Bethlehem Steel Company, Republic Steel Company, Henry Kaiser, and others. But in November 1943 they ceased operations, and on November 26 they decided to withdraw from the enterprise entirely and to sell all their shares to Kenneth E. Hall and A. M. Mears for one cent a share. Before so doing, they had the corporation give to Schnitzer Steel Products Company its promissory note for $26,829.28 and to Alaska Junk its promissory

note for $427,843.87. The amounts of these notes were equal to the respective credit balances shown on that date in the payees' open accounts with the corporation, but as later computed such balances were in fact $26,493.77 and $428,132.13, respectively. That of Alaska Junk reflected the following aggregate debits and credits (R. 50):

Debits		Credits	
Cash advanced	$327,870.23	Stock	$124,900.00
Bills paid	166,340.16	Bonds	174,000.00
Goods furnished	347,341.62	Repayments	114,519.88
Total	841,552.01	Total	413,419.88

Immediately after the sale the purchasers elected new officers and directors, Mears becoming president. Pursuant to a resolution of the new directors and with the consent of RFC, the corporation gave to Morris, Sam and Rose Schnitzer, and Harry J. and Jennie Wolf its 6 per cent note for $249,000, payable in annual installments of $24,900 beginning June 1, 1954, and secured by a second mortgage on the corporation's property. It also gave to them its 6 per cent note for $151,000, payable in annual installments of $15,100 beginning June 1, 1954, and secured by a third mortgage on its property. In consideration of these notes the payees surrendered to the corporation the debenture bonds for $249,000 and the newly made promissory notes for $26,829.28 and $427,843.87. (R. 51.)

By accepting the $151,000 note in exchange for the two newly made promissory notes, the five former stockholders of Oregon Steel failed to recover $303,625.90 of the total shown due from the corporation for their advances on open account, which at the time showed credit balances aggregating $454,625.90. Pursuant to his agreement, Morris Schnitzer made reimbursement to the other four in the amount of $83,581.20 in order to reduce their loss to two-thirds of the total. This settlement was effected by a charge of that amount to

Morris on the books of Alaska Junk and by his later delivery of second mortgage notes on account thereof to Alaska Junk. The charge of $83,581.20 was explained in the journal as follows (R. 51-52):

> To charge Morris Schnitzer with ⅓ of total loss in steel mill deal. Total investment and a/c of A. J. Co. 727,032.13; total of Morris Schnitzer 163,993.77 or 891,325.90 for both—Total payment by mrtge 400,000. Total loss 491,325.90. Morris' share of loss ⅓ or 163,775.30. His investment and a/c of 163,993.77 less his interest in two mtge notes of $83,799.67 results in loss of 80,194.10 on the amount he expended plus 83,581.20 due us.

Alaska Junk then charged off $202,350.60 on its accounts with the corporation as a bad debt. (R. 52.)

On October 3, 1943, the corporation's books indicated an operating loss to date of $59,562.91. There were small operating losses in 1944 and 1945. For 1946 the books indicate a profit of $278,196.85 before taxes. By 1947 corporate surplus exceeded a million dollars. Since November 26, 1943, and to the present time Oregon Steel has purchased large quantities of scrap from Alaska Junk. (R. 52.)

Alaska Junk's partnership return for 1942 disclosed net profits of $236,123.45, of which $64,030.86 was reported as the distributable share of Sam Schnitzer; a like amount as the share of Harry J. Wolf; and $54,030.86 as the distributable shares of each of their wives. Each of the four included such share in the income reported on his individual income tax return for 1942. Alaska Junk's partnership return for 1943 disclosed net profits of $246,055.71, of which $66,513.92 was reported as the distributable shares of Sam Schnitzer and Harry J. Wolf and $56,513.93 as the distributable shares of their wives. Each of the four included such share in the income reported on his in-

dividual income and victory tax return for 1943. (R. 52-53.)

In computing the incomes of taxpayer Sam Schnitzer and Harry J. Wolf for 1942 and 1943, the Commissioner denied recognition to the wives as partners for tax purposes, and included half of the partnership's net profits in the income of each of them. On the partnership's return for 1943 a deduction of $202,350.60 was claimed as a bad debt, represented by Alaska Junk's open account with the corporation. The Commissioner disallowed this deduction. In the event that his failure to recognize Jennie Wolf as a partner should not be sustained, the Commissioner also determined a 1943 deficiency against her estate, computed to reflect her claimed share in the partnership income as recomputed by him.[3] The Commissioner further determined that taxpayers Monte L. Wolfe, Blossom M. Goldstein, and Charlotte C. Cohon are liable for Jennie Wolf's tax deficiency as transferees of her estate. (R. 53.)

On redetermination the Tax Court held that the wives were entitled to recognition as partners of Alaska Junk for tax purposes. (R. 56-61.) The Commissioner has not appealed from this adverse holding of the Tax Court below and the partnership issue is thus not before this Court.

On the other hand, the Tax Court sustained the Commissioner's determination disallowing the deduction, as a bad debt, of $202,350.60 from Alaska Junk's part-

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[3] For the further information of this Court, the following is quoted from the Commissioner's brief in the Tax Court (p. 56, fn. 12):

> Although there is nothing in the record on this point, respondent nevertheless desires to inform the Court that * * *. No deficiency has been asserted against her [Rose Schnitzer, wife of taxpayer Sam Schnitzer] for the reason that she executed a waiver of the statute of limitations thereby permitting an assessment at a future date. No waiver was executed by the Estate of Jennie Wolf.

nership profits for 1943, holding that the advances were contributions to the capital of Oregon Steel, and hence their ensuing worthlessness was not a bad debt. (R. 61-70.) The deficiencies sustained by the Tax Court in the case of each taxpayer are the result of the conclusion of this single issue in favor of the Commissioner.

SUMMARY OF ARGUMENT

The statutory grant of the bad debt deduction is premised upon the establishment by a taxpayer of the existence of the "debts" sought to be deducted, and in applying its terms the first consideration is whether a given taxpayer was in fact owed any debt at all. Since the question is one of fact, it is primarily for determination by the trier of the facts, instantly the Tax Court, whose factual findings here sustain the Commissioner's determination and are entitled to finality, unless clearly erroneous. The burden in this Court is upon taxpayers to establish that the finding of the Tax Court, that Oregon Steel was not indebted to them for the amount sought to be deducted, was clearly wrong. Furthermore, since taxpayers base their claim upon a deduction the rule of construction is strict. The bad debt deduction, like other deductions, is a matter of legislative grace and the burden is upon taxpayers to show that the facts bring the case squarely within the terms of the legislative grant. This strict standard is not satisfied by proof of equivocal circumstances. To escape liability taxpayers must show clear indebtedness and, they do not comply with the well settled rule where, as here, reading the evidence most favorably to them they have shown only a hybrid situation.

The record facts substantiate the Tax Court's conclusion of no debt. The testimony upon which taxpayers rely was given by interested or friendly witnesses approximately five years after the events in

issue and was conclusory in character. On the other hand, there were adduced in evidence many contemporaneous record facts and documents inconsistent with the oral conclusions of these witnesses. This testimony as to intent was carefully considered by the Tax Court who saw the witnesses and observed their demeanor, candor and credibility under examination, and also which carefully found and appraised the documentary exhibits and other record facts and inferences arising from such facts. Taxpayers are not entitled, as they appear to think, to come to this Court for what virtually would amount to a trial de novo of such a finding as intent.

The Tax Court, among other things, was warranted in considering that no interest was charged at any time for the alleged loans despite the circumstances that Alaska Junk, the supposed creditor, maintained its books on the accrual basis. With the exception of formal notes given on the very day that they were cancelled and on which taxpayers sold their interest in Oregon Steel to new owners, no notes, certificates or other evidence of debt in any form were ever given by Oregon Steel to taxpayers in recognition of any of the advances, upon which the instant bad debt deduction is founded. A chronological analysis of the undisputed acts and dealings of taxpayers from the organization of Oregon Steel until they sold their interest, during the period of approximately two and one-half years, demonstrates that there is not to be found any contemporaneous clear, unambiguous and binding expression by the stockholders or otherwise that the balance on the open account of Alaska Junk was intended by them to be debt. On the contrary there were numerous contemporary statements and acts of the stockholders inconsistent with claim of debt, which the fact finder, weighing the evidence, was entitled to regard as nulli-

fying the bare and conclusory testimony of intent to loan offered at the hearing.

Moreover, during the entire period under consideration accepted indicia of debt were absent, such as fixed maturity date for payment, agreement on interest rate, accrual of interest, no subordination to creditors, divorce from management, security for payment, written evidence of indebtedness, timely and clear entry in purported creditor's books. In addition, among other criteria, sustaining the Tax Court's conclusion is the significant circumstance that this was a lending and investing transaction under which losses were matched in proportion to stockholding and were actually so computed on the taxpayers' books. Finally the Tax Court was warranted in considering the obviously excessive debt structure as against comparatively nominal stock investment, if taxpayers' claim is to be credited.

The administration of a great revenue system is a practical matter; Congress did not propose to grant deduction to ambiguous transactions, subject to treatment at a taxpayer's option as debt or investment. To expand the meaning of "debts" to include the advances involved in the instant case would, indeed, relax the strict rule of construction, which has obtained in the case of deductions under the various Revenue Acts.

The Tax Court correctly applied the relevant authorities. The primary facts may be undisputed, as substantially they are here, but conflicting inferences may reasonably be drawn from them, and it is the peculiar province of the fact finder to draw such inferences and weigh the evidence in the light of these inferences. It is not enough that an appellate court might give the facts another construction and resolve ambiguities differently. The appellate scope of review, as settled by the highest authority, is not to set aside findings of fact, unless clearly erroneous. Applying these principles

here, it is submitted that the factual conclusion reached by the fact finder, in weighing the evidence and the inferences to be drawn from it and in construing and resolving its ambiguities, was correct and certainly cannot be regarded on review as clearly erroneous.

Furthermore, in any event, should this Court hold, contrary to our contention, that debts did result from the advances, nevertheless they were not business debts and, hence, as provided by Section 23(k)(4) of the Code, are considered as a loss from the sale or exchange of a capital asset held for not more than six months and deductible only at capital loss rates. Certainly, it is not a normal incident of taxpayers' business, which consisted of selling iron and steel scrap or of selling finished steel, to go into the business of manufacturing steel, as taxpayers did.

ARGUMENT

I

The Record Amply Sustains the Conclusion of the Tax Court, That Oregon Steel Was Not in Fact Indebted to Taxpayers, Its Stockholders, in the Amount They Seek to Deduct as a Bad Debt

A. *The Issue*

Taxpayers invoke the provisions of Section 23(k)(1) of the Internal Revenue Code (Appendix, *infra*), under which Congress has "allowed" as a deduction from gross income "Debts which become worthless within the taxable year". Taxpayers contend for the deduction in full of the sum of $202,350, which they claim constituted such a bad debt. On the other hand, the Commissioner treated this amount as a loss in capital investment (R. 61), thus deductible, not in full, but at the lesser capital loss rates. See Internal Revenue Code, Section 117.

Clearly, this statutory grant of the bad debt deduction is premised upon the establishment by a taxpayer of the existence of the "debt" sought to be deducted,

and in applying its terms the first consideration is whether a given taxpayer was *in fact* owed any debt at all. *Bercaw* v. *Commissioner,* 165 F. 2d 521, 525 (C. A. 4th). Further, as the Tax Court here correctly held, this question is one of fact (R. 63), and thus, as with all factual questions, its solution varies with and depends upon the peculiar circumstances of the individual case. *John Kelley Co.* v. *Commissioner,* 326 U. S. 521; *Cohen* v. *Commissioner,* 148 F. 2d 336 (C.A. 2d).

Such fact questions are primarily for determination by the trier of the facts, instantly, the Tax Court, and its factual findings here sustaining the Commissioner's determination are entitled to finality "unless clearly erroneous". Rule 52(a), Federal Rules of Civil Procedure.[4] *Grace Bros.* v. *Commissioner,* 173 F. 2d 170 (C. A. 9th); *Joe Balestrieri & Co.* v. *Commissioner,* 177 F. 2d 867 (C. A. 9th); *Smyth* v. *Commissioner,* (C. A. 9th), decided April 5, 1950 (1950 C.C.H., par. 9267).

Rule 52 (a) further provides: "due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses". Here there was substantial oral testimony and the credibility to be afforded to the witnesses, particularly interested witnesses or those closely related to taxpayers, in view of all the circumstances of the case, is for the fact finder who saw and heard them and possessed the opportunity to observe their demeanor upon the stand.

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[4] Internal Revenue Code:

Sec. 1141 [As amended by Section 36 of the Act of June 25, 1948, c. 646, 62 Stat. 869]. Courts of Review.

(a) *Jurisdiction.*—The courts of appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; * * *.

(26 U.S.C. 1946 ed., Supp. II, Sec. 1141)

Greenfield v. *Commissioner,* 165 F. 2d 318 (C.A. 4th); *Katz Underwear Co.* v. *United States,* 127 F. 2d 965 (C.A. 3d), certiorari denied, 317 U.S. 655; *Grace Bros.* v. *Commissioner, supra,* p. 174; *Joe Balestrieri & Co.* v. *Commissioner, supra,* pp. 873-874.

Moreover, the burden in this Court is upon taxpayers to establish that the finding of the Tax Court, that Oregon Steel was not indebted to them for the amounts sought to be deducted, was clearly wrong. As this Court held in *Grace Bros.* v. *Commissioner, supra,* p. 174:

> In giving effect to these norms in a particular case, the burden is upon him who attacks a finding to show that it is clearly wrong. *In re American Mail Line,* 9 Cir., 1940, 115 F. 2d 196, 199; *Wittmayer* v. *United States,* 9 Cir., 1941, 118 F. 2d 808, 810; *Augustine* v. *Bowles,* 9 Cir., 1945, 149 F. 2d 93, 96.

Furthermore, an additional burden is incumbent upon taxpayers, both in this Court and below, inherent in the particular statutory foundation of their claim. Taxpayers base their claim upon a deduction and the bad debt deduction, like other deductions, is a matter of legislative grace. The rule of construction is strict. It does not turn upon general equitable considerations; only if there is clear provision therefor can any particular deduction be allowed. *Equitable Society* v. *Commissioner,* 321 U.S. 560, 564; *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440; *Deputy* v. *duPont,* 308 U.S. 488, 493; *Brown-Rogers-Dixson Co.* v. *Commissioner,* 122 F. 2d 347, 350 (C. A. 4th); *Pacific Southwest R. Co.* v. *Commissioner,* 128 F. 2d 815, 817 (C. A. 9th), certiorari denied, 317 U.S. 663. The burden is upon the taxpayers to show that the deduction claimed clearly falls within the terms of the statute, and, thus, includes the burden of proving

that there was an "indebtedness". *Commissioner* v. *Drovers Journal Pub. Co.,* 135 F. 2d 276, 278, 279 (C. A. 7th). In *White* v. *Commissioner,* 67 F. 2d 726, 728, this Court said:

> It is conceded by appellants, as it must be under the authorities, that no deduction from income can be claimed as a matter of right and whatever deduction may be taken is solely a matter of statutory grant. *Lloyd* v. *Commissioner* (C.C.A.) 55 F. (2d) 842. *The burden is upon the taxpayer to prove that the facts bring the case squarely within the deduction provisions of the statute.* *Burnet* v. *Houston,* 283 U.S. 223, 51 S. Ct. 413, 75 L. Ed. 991; *Reinecke* v. *Spalding,* 280 U.S. 227, 50 S. Ct. 96, 74 L. Ed. 385. (Italics supplied.)

See also to this effect *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 593, and *Boehm* v. *Commissioner,* 326 U.S. 287, 294, rehearing denied, 326 U.S. 811.

Applying this principle instantly, the taxing statute allows deduction for bad "debts" and taxpayers who seek to take advantage of the legislative grant must show facts squarely bringing them within its terms. Surely this strict standard is not satisfied by the proof of ambiguous and equivocal circumstances which may be read to point either to investment or to debt. To escape liability taxpayers must show clear indebtedness and they do not comply with this well settled rule, where, as here, the evidence reveals only a hybrid situation, which in their uncontrolled power taxpayers might interpret either way—for stock or for debt—as events transpired and their advantage proved. Certainly, in generously granting the deduction Congress did not intend and the statute should not be misread to subject the amount of his tax liability to the substantially untrammelled control of any taxpayer.

Thus, we submit the Tax Court, applying these standards to the instant record, was entitled to conclude that taxpayers had not clearly shown indebtedness to them from Oregon Steel and had not complied with the strict rule of construction of the congressional grant which they invoke; indeed, the record requires the contrary conclusion, namely, that their advances in issue, as partners in Alaska Junk to Oregon Steel, constituted risk capital and not loans.

B. *The record facts substantiate the Tax Court's conclusion of no debt*

Taxpayers' chief reliance is on the testimony of their witnesses at the hearing, especially Morris Schnitzer, that the shareholders never intended to invest more than $187,800 in stock. (R. 66.) These witnesses were either interested or close relatives of interested persons, or otherwise closely identified with Alaska Junk. Their testimony (see e.g., the parts selected by taxpayers for quotation in their brief (pp. 54-57)), consists mainly of bare and conclusory statements of intent by Morris Schnitzer or attributed by him and others to Sam Schnitzer and Harry J. Wolf. The latter had died some months prior to the hearing (R. 33), and Sam Schnitzer did not testify.[5]

The testimony, upon which taxpayers rely, was given approximately five years after the events in issue; on the other hand, there were adduced in evidence many contemporaneous record facts and documents inconsistent with the oral conclusions of the witnesses. (R. 64-70.) This testimony as to intent was carefully considered by the Tax Court (R. 66), which saw the witnesses and observed their demeanor, candor and

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[5] A physician called by taxpayers testified that Sam Schnitzer had heart trouble and his appearance as a witness might jeopardize his health. Typewritten transcript of hearing, pp. 519-525.)

credibility under examination, and which also carefully found and appraised the many documentary exhibits and other record facts and inferences arising from such facts. (R. 40-52, 64-70.) On established principles, already adverted to (subpoint A, *supra*), such weighing and analysis of the evidence was properly and primarily within the province of the fact finder. Taxpayers are not entitled, as they appear to think, to come to this Court for what virtually would amount to a trial *de novo* on the record of such a finding as intent. So the Supreme Court recently held, in *United States* v. *Yellow Cab Co.,* 338 U.S. 338, 340-342, where *inter alia,* it is said (p. 341):

> Findings as to the design, motive and *intent* with which men act *depend peculiarly* upon the credit given to witnesses by those who see and hear them. (Italics supplied.)

The Tax Court was warranted on the highest authority to afford little weight to such testimony in conflict with contemporaneous documents. *United States* v. *Gypsum Co.,* 333 U. S. 364, 396, rehearing denied, 333 U. S. 869.

The Tax Court did not err in declining to accept testimony of interested or friendly witnesses in the nature of general statements, unsupported by contemporary acts and documents, and which in the light of the entire record might reasonably be regarded as inherently improbable. *Greenfield* v. *Commissioner, supra; Grace Bros.* v. *Commissioner, supra; Joe Balestrieri & Co.* v. *Commissioner, supra.* As the Supreme Court has only recently held, in *United States* v. *National Association of Real Estate Boards,* decided May 8, 1950.

> It is not enough that we might give the facts another construction, resolve the ambiguities differently, and find a more sinister cast to actions

> which the District Court apparently deemed innocent. See *United States* v. *Yellow Cab Co.,* 338 U. S. 338, 342; *United States* v. *Gypsum Co.,* 333 U. S. 364, 394-395. We are not given those choices, because our mandate is not to set aside findings of fact "unless clearly erroneous".

Analysis of the record as a whole discloses that the Tax Court was entitled to afford weight to the following considerations which, among others, amply support its conclusion that Alaska Junk paid in the advances as contributions to capital, not as a loan:

1. The Tax Court clearly was warranted in regarding as far from conclusive the mere naming, by witnesses in oral testimony, the large advances in question made by the stockholders to Oregon Steel as "debts". Thus, even in the case of formal legal instruments in writing, it has repeatedly been held that (*In re Fechheimer Fishel Co.,* 212 Fed. 357, 360 (C. A. 2d), certiorari denied, *sub nom. Dellevie* v. *Fechheimer-Fishel Co.,* 234 U. S. 760)—

> the fact that an instrument is called a "bond" is not conclusive as to its character. It is necessary to disregard nomenclature and look to the substance of the thing itself.

The misuse of words of art cannot change the legal conclusions. *Bakers' Mutual Coop. Ass'n* v. *Commissioner,* 117 F. 2d 27, 28 (C. A. 3d); *Hazel Atlas Glass Co.* v. *Van Dyk & Reeves,* 8 F. 2d 716, 720 (C. A. 2d), certiorari denied, *sub nom. Van Dyk* v. *Young,* 269 U. S. 570; *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611, 613 (C. A. 2d); *Brown-Rogers-Dixson Co.* v. *Commissioner, supra,* p. 349.

2. Again, on analogous reasoning the circumstance that the advances entered on "open account" (R. 42) in the books of Alaska Junk and of Oregon Steel were,

as taxpayer claims (Br. 9), classified on those books as "accounts receivable" and "accounts payable", respectively, the fact finder might regard on this record as of little consequence. These accounts were simply employed as convenient places in which to record all advances by Alaska Junk to Oregon Steel, no matter what their character namely, cash, merchandise, or merchandise procured for Oregon Steel, and were without distinction debited or credited; as the case might be, with stock subscriptions, debentures issued or payments. (R. 42, 65-66). They constituted a general catch-all for transactions of many kinds between the two businesses and the name given to the accounts in the books, the fact finder properly might regard as not significant. Here again the Tax Court was entitled to look to the actual facts, not to characterizations or names. *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 187; *Thomas* v. *Commissioner,* 2 T. C. 193, 196.

3. No interest was charged at any time upon the books of Alaska Junk or otherwise by reason of the advances now claimed to be debt and *despite the circumstance that Alaska Junk maintained its books on the accrual basis.* (R. 34.) No interest was ever paid by the corporation on any advances by the stockholders. No interest was ever demanded from or promised to be paid by the corporation on any of the advances, upon which the loss here involved was realized, except on the purely temporary notes which taxpayers caused the corporation to execute for the balance of the advances, on open account, as of November 26, 1943, as an incident of the sale of their interest, and which notes were compromised with the purchasers the same day without any payment of interest. (R. 50-51.) Certainly, if taxpayers at any time had regarded the advances in question as debt absolutely payable, interest would have been accrued and credited to the taxpayer partners on account

of the alleged loans. This contemporaneous course of action, inuring to taxpayers' disadvantage, with respect to the advances is certainly more persuasive as to the true intent of the parties than the bare characterization made five years later by the friendly witnesses at the hearing.

4. With the exception of the notes above referred to, executed by Oregon Steel on November 26, 1943, immediately prior to and on the same day as the sale by taxpayers and Morris Schnitzer of their stock to the new owners (a) no notes, certificates, or other evidence of debt in any form were ever given by Oregon Steel to taxpayers or to Morris Schnitzer in recognition of any of the advances of the stockholders upon which taxpayers' claim for a bad debt deduction is founded; (b) Oregon Steel did not at any time by appropriate resolution of its directors or stockholders or otherwise recognize as debts, promise to pay, or assume liability for any of the advances by its stockholders, except to the extent of $249,000 in debentures issued as discussed, *infra*, none of which, however, is included in the alleged bad debt deduction in issue here; (c) none of the advances made by the stockholders, except those for which the various debentures were issued, were due and payable by the corporation currently or at any future date. All these circumstances also assuredly afford grounds supporting inferences by the fact finder contrary to taxpayers' contentions. *Cohen* v. *Commissioner, supra.*

5. The evidence adduced by taxpayers and the record as a whole does not satisfy a strict rule of construction. Congress intended and allowed, as is well settled by the authorities cited, *supra*, strictly bad "debts" to be deducted under Section 23 (k) (1) of the Code and nothing else. The administration of a great revenue system is an intensely practical matter; Congress did not pur-

pose to grant deduction to ambiguous advances of the character here involved, subject to treatment at the taxpayers' option as debt or investment. To expand the meaning of the term "debts" to include the advances involved in the instant case, as the Supreme Court said, in *Equitable Society* v. *Commissioner,* 321 U. S. 560, 564, "would indeed relax the strict rule of construction which has obtained in case of deductions under the various Revenue Acts."

A chronological analysis of the undisputed acts and dealings of taxpayers from the organization of Oregon Steel in June, 1941 (R. 40), until they sold their interest to the new owners on November 26, 1943 (R. 50-52), demonstrates that during this entire period of approximately two and a half years, there is not to be found any clear, unambiguous and binding expression by the stockholders, that the balance on the open account of Alaska Junk was intended by them to be debt. Taxwise, a significant aspect of this course of dealing lies in the circumstance that if the operations of Oregon Steel had been successful, taxpayers, on the basis of their record actions prior to the date of sale (November 26, 1943) might far more convincingly have denoted the ambiguous open advances as capital investments. From this it would follow that in the hypothetical successful event of their venture, taxpayers would have been in a position to claim a higher basis for their stock, i.e., by treating as investment, the advances they now urge are loans. This would, of course, under many eventualities have then inured to their advantage taxwise. It is submitted that the settled strict construction of the deduction provision, upon which taxpayers base their claim, required the trier of the facts to hold against taxpayers' contention in view of the ambiguity of taxpayers' undisputed dealings in the premises. In granting the bad debt or other deductions through exer-

cise of its legislative grace, Congress surely did not intend to permit a taxpayer vis-a-vis the Treasury to assume a position of "Heads I win, tails you lose". This consideration surely constitutes one of the important grounds for the settled rule of strict construction in deduction claims.

The following chronological statement of record facts demonstrates graphically the ambiguity of taxpayers' dealings with respect to these advances as well as further ample grounds for the Tax Court's conclusion:

June 4, 1941. Oregon Steel was organized and subscription to shares in the amount of $187,800 made. (R. 40.)

June 12, 1941. No stock was actually issued except one formal qualifying share to each of the five subscribers. (R. 41.)

June, 1941. Morris Schnitzer attempted in vain to procure outside capital from New York investment houses. (R. 43.)

October, 1941. Alaska Junk commenced to make numerous advances to Oregon Steel, supplying it with goods of various kinds and paid bills for it. The amounts of cash advanced, bills paid, and value of goods furnished were charged by Oregon Steel to its open account with Alaska Junk. (R. 42.) Similarly, Morris Schnitzer advanced cash, paid bills and supplied goods, and these amounts, together with the expenses of his business trips, were charged to the corporation's account on his books (Schnitzer Steel Products Company). (R. 42.)

These advances were made as funds were needed by Oregon Steel and were available or procurable by the stockholders, and they continued for approximately two and a half years until sale of the shares to outside parties. No advance, whether by cash payment,

materials supplied or discharge of the corporation's bills and obligations, was specifically designated as made in satisfaction of a stock subscription, in payment for bonds, or as a loan. Throughout the whole period the advances were simply charged to open accounts receivable on the books of Morris Schnitzer and Alaska Junk and credited to open accounts payable on the corporation's books, and except for formal qualifying shares, no stock was issued until February 10, 1942, and no record of payment for that was made until March 31, 1943. (R. 67.) Substantially all the advances, with the exception of $9,460 in iron scrap furnished with which to begin operations, were invested in the corporation's plant and equipment, namely, permanent assets. (R. 42, 65.)

October, 1941. Oregon Steel through its president, Morris Schnitzer, filed application with the Reconstruction Finance Corporation for a loan of $600,000. He estimated that the plant would cost $890,000, stating that capital was then $187,700, but added (R. 43-44):

> We expect to increase the capital of this corporation shortly. Additional stock will be taken by S. Schnitzer and J. Wolf to equal that of M. Schnitzer.

October, 1941. When taxpayers as partners in Alaska Junk began to charge advances to the corporation's open account, they had every reason to believe that the authorized capital of $250,000, and the subscribed capital of $187,800, were only a fraction of the minimum capital needed for the construction of a steel mill, which eventually cost $1,400,000. (R. 43, 49, 64-65.)

November, 1941. Bank of America refused loan because the authorized capital was deemed too small. (R. 43.)

February, 10, 1942. Stock for the first time actually issued. (R. 41, 67.)

April, 1942. The Bank of Portland refused loan despite oral assurances by the corporation's officers that $1,000,000 would be invested in the plant and more would be available for working capital. (R. 43.)

April 2, 1942. The executive committee of the Reconstruction Finance Corporation approved loan, subject to listed conditions. (R. 44.)

November, 1942. Actual construction of the mill began. (R. 42.)

November 30, 1942. Oregon Steel account with Alaska Junk showed a debit balance of $299,069.70, and its account with Schnitzer Steel Products Company, a debit balance of $138,984.11. Thus, at that time the open account for these advances was greatly in excess of the par value of issued stock ($187,800). (R. 42-43, 65.)

In a writing Morris Schnitzer referred to these advances as "contributed capital" (Resp. Ex. Q, admitted R. 157-159), printed in full in the footnote.[6]

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[6] OREGON ELECTRIC STEEL ROLLING MILLS

Certificate of Contributions of Capital

I, Morris Schnitzer, President of Oregon Electric Steel Rolling Mills, hereby certify that as of November 30, 1942, Alaska Junk Company, a partnership composed of Sam Schnitzer, Rose Schnitzer, H. J. Wolf and Jennie Wolf, had contributed capital to Oregon Electric Steel Rolling Mills in the sum of $299,069.70; that as of the same date I personally had contributed capital to said Oregon Electric Steel Rolling Mills in the sum of $138,984.11; that said last named amount was contributed by me under the name of Schnitzer Steel Products Company which is a registered assumed name used by me; that there will be issued to such contributors, including myself, common stock in said corporation at par in the sum of $187,700.00 and the balance in the debentures of said corporation in the form heretofore submitted to Reconstruction Finance Corporation containing a standby as to principal and interest until after the payment in full of the mortgage loan from Reconstruction Finance Corporation to said Oregon Electric Steel Rolling Mills, which debentures will be taken at par; that the authorized capital stock of said corporation is $250,000.00, and for advances made subsequent to Novem-

By inadvertence the Tax Court apparently attributed this document to Sam Schnitzer instead of to his son Morris. (R. 43.) Taxpayers' attempt to make much (Br. 9, 19) of this minor discrepancy in the Tax Court's careful and detailed findings with respect to the numerous and complex transactions between the parties, although conceding (Br. 19) "THE PRIMARY FACTS FOUND ARE CORRECT IN THE MAIN."

In any event, this inadvertence is completely harmless to taxpayers, for in Respondent's Exhibit R, quoted and discussed immediately, *infra*, Sam Schnitzer did refer there to identical advances by Alaska Junk in the sum of $299,069.70 as "contributed as a capital investment". Exhibits Q and R are obviously contemporaneous; Exhibit R is seemingly the rewritten form of Exhibit Q, and was "put in the file". The Tax Court referred to it as "an office memorandum". (R. 43.) Under the circumstances taxpayers' contention (Br. 19) that the Tax Court "seriously erred" in attributing the statement contained in Exhibit Q to Sam Schnitzer, that this inadvertence, especially in view of Sam Schnitzer's signature to Exhibit R, constituted "prejudice" and, indeed, in their asserted inability to identify the Tax Court's reference (R. 43), must be regarded as more ingenious than serious.

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ber 30, 1942 there will be issued either stock at par within the amount authorized or debenture in said form at par.

(signed) MORRIS SCHNITZER,
President,
Oregon Electric Steel Rolling Mills.

[In handwriting]:

I hereby agree as owner of Schnitzer Steel Products will accept stock or debentures in amounts of my claim of approximately $138,984.11 in full settlement of my claim against the OESRM, for materials and equipment furnished them.

MORRIS SCHNITZER.

[In handwriting]:

Mark—Altho rewritten, this may be put in the file for whatever it is worth.

REC.

December 1, 1942. Taxpayers Sam Schnitzer and Wolf as partners of Alaska Junk wrote Reconstruction Finance Corporation that the cost of the mill might exceed $1,200,000, and that Alaska Junk would furnish any necessary money in excess thereof to complete the project, if Reconstruction Finance Corporation would lend an additional $100,000. (R. 44, Resp. Ex. U.)

December 4, 1942. Reconstruction Finance Corporation approved loan of $700,000. Oregon Steel gave its note secured by a mortgage for that amount, payable within five years by monthly instalments of $6,500 from May 1, 1943, and by additional annual payments sufficient to make all payments equal to 50% of the corporation's net earnings for the preceding year. The note was secured by a mortgage. (R. 44-45.)

December, 1942. Morris, Sam and Rose Schnitzer, and Harry J. and Jennie Wolf individually guaranteed repayment of the note, and bound themselves to supply "additional working capital" in amounts deemed satisfactory by Reconstruction Finance Corporation as long as any part of the loan should remain unpaid. (R. 45.)

December, 1942. The corporation Oregon Steel bound itself to limit officers' annual salaries, as long as any part of the Reconstruction Finance Corporation loan should remain unpaid, to a total of $25,000, and to pay in cash no more than $15,000. (R. 45.)

December 29, 1942.[7] In an instrument entitled 'Agreement Regarding Capital Investment" Oregon Steel by Morris Schnitzer as president, Morris Schnitzer as sole owner of Schnitzer Steel Products Company, and Alaska Junk Company, by Sam Schnitzer, as a general partner, represented and agreed with Recon-

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[7] In the findings the date of the instrument is inadvertently stated as December 29, *1941*.

struction Finance Corporation (R. 45-46, Resp. Ex. R, admitted R. 159):

> Alaska Junk Company has contributed as a capital investment in Borrower the sum of $299,069.70, such investment being in the form of cash or of property at its true and reasonable value.
>
> Morris Schnitzer has contributed a capital investment in Borrower in the sum of $138,984.11, such investment being in the form of cash or of property at its true and reasonable value.
>
> Such contributions by Stockholders have, as stated, been as a capital investment, and in no wise as outstanding accounts payable by Borrower, except to the extent that Borrower's debenture notes may be issued for a part of such contributions or capital investment.
>
> Stockholders covenant that they will receive, in full payment of all such capital investments so made by them respectively, only the common stock of Borrower, or debenture notes of Borrower (on the form heretofore submitted to and approved by RFC, which form expressly provides that no payment of principal or interest thereon may be made prior to the repayment in full of the loan from RFC to Borrower evidenced by the latter's note for $700,000.00 dated December 15, 1942); and Borrower covenants to evidence such capital investments in no other way, or to repay any of such investments in any manner other than in the form of said debenture notes.

After its loan was made the Reconstruction Finance Corporation did allow reimbursements of subsequent advances to the amount of $114,519 (R. 46, 61), but the Tax Court was certainly not clearly wrong in inferring that the release of these corporate funds was a special favor designed to aid Alaska Junk which was then in financial straits, so that it could make advances for essential equipment of materials needed in mill construction. Thus, the Reconstruction Finance Corpo-

ration did no more than release a part of the $700,000 loan for a specific purchase for the steel mill through Alaska Junk, and in order to obtain materials needed in the mill construction. (R. 70.)

January 12, 1943. While the final terms of the Reconstruction Finance Corporation loan were being arranged, Wolf expressed dissatisfaction because Morris Schnitzer, holding two-thirds of the corporate stock, had not made a proportionate part of the advances. Cost of the enterprise had already exceeded anticipation (R. 46) and Morris was financially unable to advance more. Pursuant to an oral agreement, Morris Schnitzer promised taxpayers that he would bear one-third of any loss that might result from the total amounts advanced by the partners of Alaska Junk and himself to the corporation, over and above the advances credited to stock subscriptions. Alaska Junk, in turn, agreed to bear two-thirds of any such loss. Morris Schnitzer and Alaska Junk continued thereafter to make advances as before and these advances were credited to their open accounts with the corporation in the same way as before and charged to the corporation's open account with them. (R. 48.)

Debenture bonds in the amount of $249,000 were issued to the stockholders on terms contemplated by the understanding with Reconstruction Finance Corporation. (R. 46-47.) Of these bonds, the partners of Alaska Junk received a total of $174,000. The bonds bore 8% interest and were payable within ten years of issue, and no payment of interest or principal could be made while any balance remained due on the corporation's $700,000 note to Reconstruction Finance Corporation. (R. 46-47.)

March 11, 1943. As further part of the settlement agreement with Morris Schnitzer, he surrendered ap-

proximately half of his shares of stock, and these were reissued to the partners of Alaska Junk so that the corporation's outstanding 1,878 shares were thereafter held approximately two-thirds by the partners of Alaska Junk and one-third by Morris Schnitzer. (R. 47, 67.)

March 31, 1943. For the first time entries were made on the books of Oregon Steel of payment for the corporate shares. These entries were made in the open account with Alaska Junk and were for the shares, not as originally issued but as redistributed. At the same time credits were made in the open account regarding payment for the debentures, namely, in the amount of $174,000 on account of the debentures, and $124,900 in payment for stock at its par value. Nevertheless, after these credits were taken, there still remained over $315,000 in the open account, which is reflected in the ultimate balance that taxpayers now seek to characterize as a loan. (R. 47-48, Pet. Ex. 17, p. 4, Account of Alaska Junk, General Ledger, Oregon Steel.) It is significant as throwing further doubt upon taxpayers' claim, that on Alaska Junk's own books corresponding entries of this neat sum aggregating $298,200 for payment of stock and debentures were not made until July 14, 1943. (R. 47-48, Pet. Ex. 26, p. 64, General Account of Oregon Steel on books of Alaska Junk.)

The Tax Court was warranted in inferring from this delay (R. 68)—

> we can not but share the bookkeeper's probable feeling that the entries made little difference anyhow because the advances were all of the same character and could be distributed as desired among accounts for capital contributed, bonds issued and loans payable.

March 18, 1943. Morris Schnitzer wrote Reconstruction Finance Corporation that costs were rising and that (R. 48)—

> the stockholders had "in this job over $700,000 of our own money," but "never originally intended to put in over * * * the $500,000 we were supposed to put in as our share in the capital investment."

March 31, 1943. Even after the March, 1943, settlement, Alaska Junk continued to make large advances to Oregon Steel so that by November 26, 1943, their total from the beginning aggregated over $800,000 (R. 50-51, 65), and substantially all, with the possible exception of $9,460 in iron scrap, had apparently been invested in the corporation's organization and plant, as a permanent asset (R. 65).

June, 1943. Mill finally completed at a cost of $1,400,000, and the melting of scrap into ingot started. (R. 49.)

June, 1943. Morris Schnitzer entered military service. (R. 49.)

June, 1943. Oregon Steel began to borrow relatively small loans from banks. (R. 49.)

July 14, 1943. As above noted, entries first made in Alaska Junk's books on its open account of credits reflecting payment for stock and debentures, which had been made in Oregon Steel's books on March 31, 1943. (R. 47-48.)

November, 1943. Small loans from banks secured by steel inventory and warehouse receipts for scrap, aggregated approximately $150,000. (R. 49.)

November, 1943. Operations of mill unsuccessful and stockholders decided to cease operations and to dispose of property. (R. 49-50.)

November 26, 1943. Stockholders sold all their shares to Hall and Mears for nominal amount of one cent

a share. Before so doing, and on the same day, they had the corporation give to Schnitzer Steel Products (Morris Schnitzer) its promissory note for $26,829.28, and to Alaska Junk its promissory note for $427,843.87, which were equal to the respective credit balances shown on that date in the payees' open accounts with the corporation. (R. 50-51.) As part of the price of the sale, Alaska Junk received from the purchasers new 6% notes of Oregon Steel in the amount of $174,000, being the face amount of the debentures already issued, and in addition, $142,200.33 in new notes of the purchasers in exchange for the former debentures and the newly made notes of the same day. (R. 51, 61.)

November 26, 1943. The entry of this date in the open account on Alaska Junk's books (R. 51-52, 69, Pet. Ex. 26), being the last entry preceding transfer of the account to "Bad Accounts", computed the amount due from Morris Schnitzer, by reason of his agreement to bear one-third of the loss, and computed the loss on the basis of the total advances of Morris and Alaska Junk from the beginning, not merely on the basis of the amounts in open account remaining after credits for stock subscriptions and bonds (R. 391-397; Pet. Ex. 66). Thus, the total loss was regarded by taxpayers as including all advances, whether contributed to stock, bonds, or loans, and *in proportion to stockholdings.* This, the Tax Court was entitled to deem "a considered expression of the parties' own view". (R. 69.)

In summary then, from these record facts the Tax Court was entitled to infer that all along no clear intent existed to treat the advances here involved as debt and that not until the very day of the sale to outside parties, November 26, 1943, was it decided to designate them as debt, which was done by way of the purely temporary expedient of a note cancelled the same day.

Thus, there is certainly present here (*John Kelley Co.* v. *Commissioner, supra*, p. 525)—

> the wholly useless temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering*, 293 U. S. 465.

No evidence of indebtedness was issued until the moment of the alleged debt loss. Since taxpayers conducted their transactions thus enigmatically, they cannot complain if, especially where a claim of deduction is involved, the fact finder construed them to constitute what they were in substance, i.e., investments in permanent capital assets. At the time the debentures were issued in March, 1943, and payment for the stock credited against the open account, as has been seen, over $300,000 still remained in the open account, which is reflected in the ultimate balance that taxpayers now seek to characterize as a loan. (R. 47, 68.) The Tax Court was entitled to infer that had taxpayers actually regarded this open balance as debt and not capital investment, it would have been so allocated at the time the debentures were issued. Instead, for a period of approximately eight months thereafter during which Alaska Junk continued to make large advances (R. 65), no such allocation was made. Moreover, for a substantial period after March 31st, the stockholders obviously retained optimism of eventual success. The mill started operation in the following June, 1943, and it was not until then that Morris Schnitzer entered military service. (R. 49.) Operations continued, as has been seen, through October, 1943, and taxpayers may well have regarded it as to their advantage to treat the balance in open account as investment during all of this time. The Tax Court might infer that not until it was concluded that the venture was a failure, was an

effort made definitely to designate this balance as loans. Congress intended to allow the bad debt deduction only in clear cases of debt; otherwise, contrary to the public interest, a taxpayer may play fast and loose with his tax obligation.

Moreover, during the entire period under consideration, accepted indicia of debt were absent, such as fixed maturity date for payment, agreement on interest rate, accrual of interest, no subordination to creditors, divorce from management, security, written evidence of indebtedness, timely and clear entry in purported creditor's books. Under these circumstances the extensive priority granted to the Reconstruction Finance Corporation loan, under which the corporation could not make payments on any account to stockholders, except $15,000 annually as salaries, the Reconstruction Finance Corporation mortgage, the pledging of inventory and like assets, not covered by the Reconstruction Finance Corporation mortgage, to secure bank loans (R. 68), and the execution of debentures as to part of the advances, in the aggregate, constitute practically an admission that the balance of the advances were intended to be risk capital; certainly this interpretation holds taxwise in strict construction of a deduction from gross income.

As a matter of fact, there is no ambiguity in taxpayers' transactions. The numerous contemporary statements and acts of the parties inconsistent with claim of debt, set forth in detail above and in the Tax Court's findings (R. 43-46, 48-49, 67-69), nullify the conclusory testimony of intent to loan offered at the hearing. Certainly, on this record the trier of the facts, weighing the evidence, might properly so find.

Taxpayers and Morris Schnitzer completely managed and controlled as well as owned their alleged debtor. (R. 41-42.) As this Court held in *Wilshire*

& *West. Sandwiches* v. *Commissioner,* 175 F. 2d 718, 21:

> The effect of a lending and investing transaction giving creditors, as stockholders, proprietary interest in proportion to their loans, subjects the transaction to close scrutiny,

ven though, as a matter of law, the transaction need ot be regarded as a stock investment, regardless of ntent. The proportional financial interest of taxayers in Oregon Steel was exactly the same, whether reated as stockholders or creditors, as appears from he stockholders' agreement, the closing entry on the laska Junk books (R. 69) and the testimony of Iorris Schnitzer (R. 127-128). The Tax Court might roperly regard, as it did, the mere existence of such n agreement incompatible with testimony that reayment of advances was anticipated or with their haracterization as loans and, further, that such a mitation is an incident of stock ownership, not of a ebtor-creditor relation. (R. 69.) Thus, subjecting ie instant transaction to "close scrutiny", the Tax 'ourt was warranted in concluding from all the cirumstances that no debt transaction was involved.

6. Another factor whereby the Tax Court was waranted and did test the reality of the claim by these ockholders of a debtor-creditor relationship is strikigly present in this record, namely the ratio of debt, n the face of their claim, to investment. (R. 66.) 'specially in view of the ambiguity and inconsistency f taxpayers' transactions with Oregon Steel, this riterion derives significance here. The instant situaon is that of "an obviously excessive debt structure", dverted to by the Supreme Court in *John Kelley Co.* . *Commissioner, supra,* as follows (p. 526):

> As material amounts of capital were invested in stock, we need not consider the effect of extreme

situations such as nominal stock investments and an obviously excessive debt structure.

Thus under taxpayers' claim here, the capital invested in stock amounted to $187,800 as against a debt structure of more than $1,500,000. (Balance Sheet, Oregon Steel, October 31, 1943, Pet. Ex. 19.) Again, as against an asserted investment of only $187,800, according to taxpayers' claim, the corporation owed to its stockholders a total of more than $700,000. With respect to a similar situation the Court of Appeals for the Fifth Circuit in *Arnold* v. *Phillips,* 117 F. 2d 497, certiorari denied, 313 U. S. 583, held as follows (p. 501):

> Those [advances] made before the enterprise was launched were, as the district court found, really capital. Although the charter provided for no more capital than $50,000, what it took to build the plant and equip it was a permanent investment, in its nature capital. There was no security asked or given. Arnold saw that he could not proceed with his enterprise unless he enlarged the capital. There can be little doubt that what he contributed to the plant was actually intended to be capital, notwithstanding the charter was not amended and demand notes were taken. The district court was justified in concluding as a matter of fact that the advances during the first year were capital, a sort of interest-bearing redeemable stock; and that as a matter of law these contributions could not, as against corporate creditors, either precedent or subsequent, be turned into secured debts by afterwards taking and recording a trust deed to secure them. *There was no debt to be secured.* (Italics supplied.)

While the cited case arose in a bankruptcy situation, it is notable that the holding of the court is placed upon the broad ground, irrelevant to bankruptcy, that "There was no debt to be secured". Here also

substantially all the stockholders' advances were invested in original plant and equipment, namely, permanent capital investment.

Again, in a case where the attributes of legal form were far more fully complied with than in the instant record, the Tax Court in *1432 Broadway Corp.* v. *Commissioner,* 4 T.C. 1158, 1164-1165, said:

> The debentures are in approved legal form, and, if their legal attributes alone were determinative of the character of the interest accruals, there would be little room for doubt that they were the indebtedness they purport to be. Cf. *Clyde Bacon, Inc.,* 4 T. C. 1107. But, for tax purposes, their conformity to legal forms is not conclusive. Although a taxpayer has the right to cast his transactions in such form as he chooses, and the form he chooses will generally be respected, the Government is not required to acquiesce in the taxpayer's election of form as necessarily indicating the character of the transaction upon which his tax is to be determined. "The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." *Higgins* v. *Smith,* 308 U. S. 473. See also *Commissioner* v. *Court Holding Co.,* 324 U. S. 331. The Government is not bound to recognize as the substance or character of a transaction a technically elegant arrangement which a lawyer's ingenuity has devised. *Griffiths* v. *Commissioner,* 308 U. S. 355.

The cited case was affirmed by the Court of Appeals for the Second Circuit in 160 F. 2d 885, where it was pointed out that the Tax Court had "denied deduction on the ground that the evidence did not show that the debentures were, or were intended to be, evidences of indebtedness'; they were 'more nearly like

preferred stock than indebtedness'." While the Court of Appeals, in view of the *John Kelley* case, *supra,* regarded these conclusions as not within the scope of its judicial review, it further stated:

> We may add, however, that, if the question were open to us, we should reach the same result as did the Tax Court.

See also to the same effect *Thomas* v. *Commissioner,* 2 T. C. 193; *Janeway* v. *Commissioner,* 2 T. C. 197, affirmed, 147 F. 2d 602 (C.A. 2d); *Swoby Corp.* v. *Commissioner,* 9 T. C. 887; Semel, Tax Consequences of Inadequate Capitalization, 48 Columbia L. Rev. 202 (March, 1948).

Again, the Tax Court was warranted in considering the testimony at the hearing to the effect that the ratio of investment to debt in a soundly financed similar enterprise is expected to be two to one, or at the least one to one. The owners of the business should have as much or more in it than the creditors. (R. 430-433, 504-505, 519.)

On the other hand, the Tax Court was warranted in finding unpersuasive, the taxpayers' claim that they reasonably anticipated such large operation profits from the new venture as to pay off this overwhelming debt structure. This claim is refuted, for example, by the acceptance of debentures in the amount of $249,000 absolutely due only in ten years and subject to the R.F.C. mortgage of $700,000. The circumstances that in the hands of experienced owners and, due inferentially to the requirements of the war, Oregon Steel did earn large profits for the new owners, could not require in view of all the circumstances, the Tax Court, as a matter of law, to be persuaded by taxpayers' contention with respect to repayment. (R. 66.)

C. The Tax Court correctly applied the relevant authorities

As already discussed in subpoint A, *supra,* the issue here is one of fact. Hence, since each case is necessarily confined to its peculiar facts, the numerous authorities, some of which have already been cited, dealing with similar questions,[8] namely, whether an advance by a stockholder is to be regarded as a loan or as a capital contribution, for purposes of asserted bad debt or interest deductions are helpful principally as guides. Indeed, in many instances, it is impossible to select single factors which can be pointed to as decisive, for elements both of obligation and of stock are commonly embodied in the evidence. The primary facts may be undisputed, as substantially they are here, but conflicting inferences may reasonably be drawn from them, and it is the peculiar and primary province of the fact finder to draw these and weigh the evidence in the light of these inferences. This is the lesson of the *John Kelley* case, *supra,* where the Supreme Court declared (p. 530):

> The Tax Court is fitted to decide whether the annual payments under these corporate obligations are to be classified as interest or dividends. The Tax Court decisions merely declare that the

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[8] See, e.g., *Wilshire & West. Sandwiches* v. *Commissioner, supra; Maloney* v. *Estate of Spencer,* 172 F. 2d 638 (C. A. 9th); *1432 Broadway Corp.* v. *Commissioner,* 4 T. C. 1158, affirmed, 160 F. 2d 885 (C. A. 2d); *Cohen* v. *Commissioner, supra; Janeway* v. *Commissioner,* 2 T. C. 197, affirmed, 147 F. 2d 602 (C. A. 2d); *Van Clief* v. *Helvering,* 135 F. 2d 254 (C. A. D.C.); *Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182 (C. A. 7th); *Pacific Southwest Realty Co.* v. *Commissioner,* 128 F. 2d 815 (C. A. 9th), certiorari denied, 317 U. S. 663; *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611 (C. A. 2d); *United States* v. *South Georgia Ry. Co.,* 107 F. 2d 3 (C. A. 5th); *Commissioner* v. *Proctor Shop,* 82 F. 2d 792 (C. A. 9th); *Commissioner* v. *O.P.P. Holding Corp.,* 76 F. 2d 11 (C. A. 2d).

> undisputed facts do or do not bring the payments under the definition of interest or dividends. The documents under consideration embody elements of obligations and elements of stock. There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporation or debts.

While, subsequent to the decision in the *John Kelley* case, the scope of review over factual decisions of the Tax Court has, of course, been extended, through the legislative repeal of *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231, by amendment to Section 1141 (a) of the Internal Revenue Code (see fn. 4, *supra*), the essential factual nature of the problem remains the same,[9] and in this important respect, among others, the rule laid down by the Supreme Court in the *Kelley* case remains the law. Thus, although, since the demise of *Dobson,* the appellate courts are not limited in review of Tax Court decisions to clear cut questions of law, nevertheless, the Tax Court or the District Court remain the fact finders, and as the Supreme Court recently pointed out in *United States* v. *National Association of Real Estate Boards, supra,* it is not enough that an appellate court might give the facts another construction or resolve the ambiguities differently, the appellate scope of review is limited "because our mandate is not to set aside findings of fact 'unless clearly erroneous'." Applying these principles here, it is submitted that the factual conclusion reached by the fact finder in weighing the evi-

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[9] See, to the same effect, *Boehm* v. *Commissioner, supra,* p. 293, where the Supreme Court said:

> The circumstance that the facts in a particular case may be stipulated or undisputed does not make this issue any less factual in nature. The Tax Court is entitled to draw whatever inferences and conclusions it deems reasonable from such facts.

lence and the inferences to be drawn from it, constru-
ng and resolving its ambiguities, was correct and
ertainly cannot be regarded on review as clearly er-
oneous.[10]

Similarly on these principles the decision below for
nany reasons cannot fairly be regarded in variance
vith the recent decisions of this Court in *Maloney* v.
Spencer, supra, and *Wilshire & West. Sandwiches* v.

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[10] Taxpayers also argue that the Tax Court failed to make find-
ngs with respect to advances made to a certain National Machinery
Company and Hesse Ersted Company, supposed to be indicative
f other transactions, and in the case of the first of which a bad
ebt deduction had been taken. (Br. 21-22.) It is asserted that
onsideration to these items was necessary in order for the Tax
Court to give proper weight to the record. (Br. 22.) However,
imilar items were explicitly found by the Tax Court (R. 38-39),
nd it is certainly not necessary for the trier of the facts to advert
o every detail of a long record in its findings nor reasonable to
ssume that aspects of the evidence were disregarded, merely be-
ause explicit mention is not made of them.

Taxpayers further criticize the statement in the findings (R. 42):

> From October 1921 Alaska Junk made numerous advances of cash to Oregon Steel; supplied it with goods of various kinds at cost and paid bills for it. The amounts of cash advance, the bills paid and value of the goods furnished were charged to its open account with Alaska Junk

n the ground that the goods were not supplied "at cost" (Br.
9-21). The record contains evidence, however, that the goods
vere certainly sometimes supplied at cost. (R. 215-216.) More-
ver, it is obvious that there is no parallel between the advances
f merchandise here intended to form part of the permanent struc-
ure of Oregon Steel and advances of merchandise by a manu-
acturing parent corporation to a sales subsidiary for general
istribution to the public. In any event, any inaccuracy in com-
leteness of the statement criticized was harmless and does not
ndicate that the Tax Court misunderstood the situation in prejudice
o the result, for, as the Tax Court subsequently noted (R. 670):

> No advance, whether by cash payment, materials supplied or discharge of the corporation's bills and obligations, was specifically designated as made in satisfaction of a stock subscription, in payment for bonds, or as a loan.

The primary facts found by the Tax Court, covering the mass of
vidence and exhibits introduced and a complex factual situation
vere concededly "correct in the main". (Br. 19.)

Commissioner, supra, as apparently taxpayers contend. (Br. 11, 46-48.) This case depends on its facts and those on theirs. Moreover, in the *Spencer* case, the factual conclusion of the District Court was affirmed. In addition there, for instance, this Court emphasized the consistent treatment both in actions and bookkeeping of the parties throughout the taxable years in regard to the advances (p. 641), evidencing the debtor-creditor relation, as well as notes given by the taxpayers to the corporations, absent in the instant case. Here, as particularized above, there was substantial evidence in books, transactions and writings, inconsistent with the claim of debt.

Again, in *Wilshire & West. Sandwiches, supra,* while this Court reversed the Tax Court finding and sustained an interest deduction, the facts there are in striking contrast with those here. Promissory notes maturing in two years at 6% interest, payable quarterly, were issued there for the asserted loans, and though not paid in time, were paid in full, both as to interest and principal. Further, this Court placed special emphasis upon the finding of the Tax Court there that the parties originally actually intended to loan the money. Indeed, this Court's disagreement with the Tax Court in the cited case seems essentially limited to the latter's inference from other facts and circumstances that the original intent to loan was subsequently nullified.

Thus, the cited case has little bearing here, where, for example, no notes were ever given, except the merely formal and temporary ones made on the day they were cancelled, November 26, 1943, and substantially as part of the sale of the stockholders' interest in Oregon Steel to outside parties. Here no interest was charged, demanded, accrued or paid. Again, here the Tax Court made no finding of intent to loan at any time. Surely, subjecting here the asserted lending and investing

ransaction, giving creditors, as stockholders, proprietary interest in proportion to their alleged loss, o the "close scrutiny" which this Court in the cited ase (p. 721) declared proper, the Tax Court's concluion on the instant record of no debt is completely compatible with the decision of this Court in the cited case. While here, also, as there, there may be features lookng both ways, it surely was not clear error for the Tax Court to conclude on this very different record from hat involved in *Wilshire & West. Sandwiches*, that the eatures sustaining an investment transaction here predominated.

Certainly, the decision of the instant issue is not determined solely by the parties conclusory characteriations of their intent and the Tax Court did not err in weighing the evidence in the light of all of the indicia (R. 63-64) above referred to and repeatedly recognized nd applied in *John Kelley Co.* v. *Commissioner, supra,* nd other authorities above cited. (Fn. 8.)

II

n Any Event, the Loss Did Not Occur in Taxpayers' Trade or Business and the Amount of the Deduction Is under Section 23 (k)(4) of the Code Limited to Capital Loss Rates

Furthermore, should this Court hold, contrary to ur contention in Point I, *supra,* that debts did result rom the advances, nevertheless they were not business lebts and, hence, as provided by Section 23 (k) (4) f the Code (Appendix, *infra*), are considered as a loss rom the sale or exchange of a capital asset held for not more than six months and deductible only at the apital loss rates. (Sec. 117.) The Tax Court, in view f its decision in favor of the Commissioner that the dvances did not result in a bad debt, found it unnecesary to consider this contention with respect to the busiess character of the alleged loan (R. 70), also made

by the Commissioner below (R. 62). However, the Tax Court did make fact findings with respect to loans or advances occasionally made to customers by Alaska Junk in the expectation of maintaining or increasing its trade, and also that Alaska Junk made very large advances to enterprises in which members of the Wolf and Schnitzer family were interested. (R. 38-40.)

Section 23 (k)(4) defines a "non-business debt" as "other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." The pertinent Treasury Regulations (Regulations 111, Sec. 29.23 (k)-6, Appendix, *infra*), provides:

> The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23 (e) is "incurred in trade or business" under paragraph (1) of that section.
>
> The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this section.

Applying this standard, quoted from the pertinent Regulations, that—

> the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer

the findings (R. 38-40) merely show that taxpayers went into various lines of business together, which they as entrepreneurs necessarily financed themselves. There is no evidence that they financed any other business enterprises as such in which they had no financial interest. True, they made advances to haulers and contractors in the nature of prepayments for hauling or procuring iron and steel scrap for them, but this is a far cry from the financing business. The Tax Court found that Alaska Junk was (R. 33-34)—

> engaged in the business of buying, selling and generally dealing in junk, pipe, tools, machinery, hardware, scrap and other metal products in Portland as, indeed, it is in substance stipulated (R. 529).

Certainly it is not a normal incident of the business of selling iron and steel scrap or of selling finished steel to go into the business of manufacturing steel as taxpayers did. To say so is to say that the tail can wag the dog. The factual situation here is readily differentiated from that in *Maloney* v. *Spencer, supra.*

Moreover, the situation here does not fall within any one of the six illustrations contained in the controlling Regulations (Appendix, *infra*), which clarified the meaning of the proximate relationship there defined; for every illustration reflects a debt resulting from a sale of goods in the ordinary course of business. Here, while part of the advances consisted of merchandise from the inventories of Alaska Junk, such advances did not involve sales in the regular course of business. Moreover, even if they did, there is no evidence to show that part, if any, of the remainder of the advances upon which the loss here claimed was sustained, consisted of these mechandise advances as distinguished from cash advances.

It is therefore respectfully submitted that the debts, if such they were, were non-business debts and that the

deduction for loss thereon must be limited in amount t capital loss rates in accordance with the mandate c the statute.

CONCLUSION

The decisions of the Tax Court are correct and shoul be affirmed.

Respectfully submitted,

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MAY, 1950.

APPENDIX

Statute and Regulations Involved

Internal Revenue Code:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * *

(k) [As amended by Section 124 (a) of the Revenue Act of 1942, c. 691, 56 Stat. 798, and Section 113 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] Bad Debts.—

(1) *General Rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

* * * * *

(4) *Non-Business Debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph

(3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23 (k)-6 [As amended by T. D. 5458, 1945 Cum. Bull. 45]. NON-BUSINESS BAD DEBTS.—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23 (k)(3). A non-business debt is a debt other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23 (k)(3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23 (e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its crea-

tion or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct

of the trade or business in which he was engage
at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to hi
son, C, but the claim against B to his son, D, th
taxpayer. The claim against B becomes worthles
in D's hands in 1943, at a time when D is not en
gaged in a trade or business incident to the conduc
of which a loss from the worthlessness of such
claim would be a proximate result. D's loss i
controlled by the nonbusiness debt provisions, eve
though the original consideration was advance
by A in his trade or business.

(5) In 1942 A dies and while his executor, C, i
carrying on the business, the claim against B be
comes worthless. The loss sustained by A's estat
is not controlled by the nonbusiness debt provi
sions. While C did not advance any consideratio
for the claim on behalf of the estate or acquire i
in carrying on a trade or business in which th
estate was engaged, the loss was sustained as
proximate incident to the conduct of the trade o
business in which the estate was engaged at th
time the debt became worthless.

(6) In 1942, A, in liquidating the business, at
tempts to collect B's claim but finds that it ha
become worthless. A's loss is not controlled by
the non-business debt provisions, since a loss in
curred in liquidating a trade or business is a proxi
mate incident to the conduct thereof.

The provisions of this section with respect to non
business debts are applicable only to taxable year
beginning after December 31, 1942.

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